Political Influence and Financial Flexibility: Evidence from China

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Abstract

This paper investigates how political influence affects firms' financial flexibility and speed of adjustment toward target leverage ratios. We find that at the macro level, firms in environments with high political advantages, proxied by provincial affiliations with heads of state as well as political status and party rank of provincial leaders, adjust faster. At the micro level, firms that are state-owned, have CPC members as executives, or bear low exposure to changes in political uncertainty adjust faster. When interacted, the micro-level political factors have more significant impact.

JEL: G30, G32, P16

1. Introduction

Political influence and economy are inseparable, and in the modern world, political influence has become increasingly powerful in determining economic outcomes. A large body of recent work studies such impact (Bloom, Bond, and Van Reenen, 2007; Alesina, 1987; Alesina and Roubini, 1992; and Pastor and Veronesi, 2013; among others) and finds that political influence, including macro-level political environment and micro-level firm-specific political connections, significantly affects firms' decision-making and their overall performance.

The main macro-level political impact comes from alternating political power and changes in regulations and policies. Presidential elections are one example.[1] Prior to an election, firms operate under the possibility that certain unforeseeable political situations may result in erroneous decision-making and deteriorating performance. After an election, subsequent changes in regulation, as well as in fiscal, monetary, and foreign policy continue to exert long-term influence on firms' decision-making.[2] Such shifts in policies may directly affect how firms make investment decisions (Julio and Yook, 2012 and 2016), how they receive and raise capital, and how much they pay for capital (Houston, Jiang, Lin, and Ma, 2014; Colak, Durnev, and Qian, 2017).

At the micro-level, political connections play a bigger role in firms' daily operations. Firms make political investments in the form of political contributions, lobbying, and

[1] A sizable number of studies (e.g., Santa-Clara and Valkanov 2003; Julio and Yook, 2012, 2016; Colak, Gungoraydinoglu, and Öztekin, 2017; Gungoraydinoglu, Colak, and Oztekin, 2017) examine political influence at the state level using presidential elections as the major source of political uncertainty and political risk. Jens (2017), Colak, Durnev, and Qian (2017) and Gao and Qi (2013) use U.S. gubernatorial elections as a proxy for political uncertainty.

[2] In terms of policy-making, a ruling party may hold very different views from those of the opposition party, leading to discernible business cycles in certain industries, geographic areas, and business groups. The impact can be profound and prominent in certain industries, as well as in countries with less developed legal and political systems. For example, Hong and Kostovetsky (2012) show that in the United States, Democrats are more apt to support environmental and labor causes and oppose smoking, guns, and defense. Belo, Gala, and Li (2013) support this; their study shows that industries with high government exposure experience higher cash flows and stock returns during Democratic presidencies, but the opposite pattern holds during Republican presidencies. Researchers also document that firms facing such uncontrollable forces of uncertainty may postpone projects and financing decisions (Bernanke, 1983; Bloom, Bond, and Van Reenen, 2007; Colak and Gunay, 2011), cut investment (Julio and Yook, 2012 and 2016), and incur higher financing costs (Houston, Jiang, Lin, and Ma, 2014; Drobetz, El Ghoul, Guedhami and Janzen, 2018 and Colak, Durnev, and Qian, 2017).

offering advisory positions, in particular.[3] Such activities certainly "grease the skids" as far as preferable treatment is concerned. For example, firms with stronger political connections receive more government investment (Duchin and Sosyura, 2012; Cohen, Coval, and Malloy, 2011; and Goldman, Rocholl, and So, 2009), are more likely to be bailed out in a financial crisis (Faccio, Masulis, and McConnell, 2006), and are less likely to be charged with fraud (Yu and Yu, 2011). These firms also tend to demonstrate better performance (Faccio, 2006; and Cooper, Gulen, and Ovtchinnikov, 2010). One stream of research in this area examines capital-structure decisions (Cao, Duan, and Uysal, 2013), and the cost of capital (Qi, Roth, and Wald, 2010; Gao and Qi, 2013; Francis, Hasan, and Zhu, 2014; Anginer, Demirgüc-Kunt and Mare, 2018, Waisman, Ye, and Zhu, 2015). However, it remains unclear how political influence affects a firm's *collective* decision-making regarding its optimal capital structure. It is thus natural to investigate how macro-level and micro-level political influence affects a firm's capital-structure decisions and financial flexibility.

How firms determine their capital structures is one of the most fundamental and classic questions in corporate finance. Although a firm's capital structure does not yield perceivable benefits under the classic Modigliani-Miller theorem, a number of arguments, such as trade-off, pecking order, and market-timing theories, point to the impact of capital structure on firm-level decision making and consequently on firm performance and value. More specifically, what type of capital to raise, when, and at what cost are all relevant, central questions.

A critical question remains, however, regarding how firms maintain their financial flexibility and adjust their capital structures under political influence. According to the well-circulated Graham and Harvey (2001), a majority of firms manage their capital structures around target leverage ratios. A number of empirical studies (e.g., Hovakimian, Hovakimian, Tehranian, 2004; Baker and Wurgler, 2002; Flannery and Rangan, 2006; Lemmon, Roberts, and Zender, 2008) work around this assumption, providing evidence that firms maintain relatively stable capital structures and actively manage them toward

[3] For example, Google spent $16,830,000 on lobbying in 2014, part of which was in the form of political donations to 162 members of the U.S. Congress in the latest election cycle. (opensecrets.org)

target leverage ratios. Firms vary in their endeavors and ability to adjust, and they wait for good opportunities to make cost-efficient adjustments (Baker and Wurgler, 2002; Leary and Roberts, 2005). An empirical approach to identifying financial flexibility is to quantify a firm's speed of adjustment (SOA) toward a long-term target leverage ratio. A higher SOA indicates the firm is converging on the targeted leverage ratio faster and thus is more financially flexible. This facilitates other firm-level decision-making and contributes to firm value and performance.

Connecting with the aforementioned evidence that political factors affect a firm's cost of capital, government investment and purchases, detection of financial fraud, and other factors, it is unclear what *collective* impact these mechanisms, directly or indirectly, have on capital-structure decisions and financial flexibility. This paper fills that gap and examines political influence on speed of adjustment.

We conduct the empirical analysis using political data from China. This choice offers several advantages. First, China is politically oriented, politically corrupt, and bureaucratic (see, e.g., Allen, Qian, and Qian, 2005; Fan, Wong, and Zhang, 2007; Li and Zhou, 2005). Undeniably, political influence pervades every aspect of the fast-changing society, and a political way of thinking is embedded in almost all major firm-level decisions, especially for public firms. In addition, a sizeable number of public firms are state-controlled, making it easier to track and quantify state interest and influences. Second, information about firm-level political connections is readily available for publicly listed firms in China. In the United States and European countries, political contributions only implicitly capture such political connections, social network connections, and other inferred channels. Third, in China, a typical public firm's capital structure is relatively simple, with major external financing from short-term bank loans, as opposed to long-term corporate bond and seasonal equity offerings in the United States. This simplifies the empirical challenge of our investigation and makes it easier for firms to adjust their capital structures quickly. Last, China's single-party political structure eases the quantification of political influence, as well as lessens concerns of bipartisan government control and politically induced business cycles (e.g., Allen, Qian, Shan, and Zhao, 2014).

We employ two sets of measurements for political influence. At the macro level, we examine the affiliations between provincial leaders and heads of state, the power status of the incumbered provincial leaders and the degree of political pluralism within the province. At the micro level, we first adopt measures of firm-level political connections and state ownership. Then we create a firm-level time-variant measure of exposure to political environment using the Political Uncertainty Index from Baker, Bloom, and Davis (2012).

At both levels, we find consistent results that political factors positively affect firms' speed of adjustment. For example, in provinces where leaders possess greater political power, firms' SOA is 48% higher than in other provinces.[4] Firms with better connections to the Communist Party of China (CPC) also have higher SOA than those with weaker political connections. Although political connection may be exogenous to firm-level capital-structure decisions, we strengthen the causal link by employing China's provincial emigration policy as an exogenous shock. The results remain robust and economically unchanged.

By documenting that stronger political environments and political connections enhance a firm's financial flexibility, this paper makes a number of contributions to the literature. First, it is the first to conduct a comprehensive investigation of how political influence affects firms' financial flexibility given a variety of political factors at macro and micro levels. The dual-level approach not only unveils a more complete picture of political influence, but also deepens our understanding of the joint impact of political environment and political connection. The finding that micro-level political connections are more important than macro-level political environment in affecting financial flexibility sets this paper apart from extant works, including Colak, Gungoraydinoglu, and Öztekin (2017), which looks at the impact of country-level political uncertainty on firm leverage and capital structure.

Second, because capital structure constitutes the foundation of the modern corporation and affects almost all firm-level decision-making, this paper builds solid ground for future

[4] If a provincial leader becomes a member of the Politburo, the SOA during his/her regime is 28.0%, compared with an SOA of 18.9% if the province leader was not promoted to such an elite level.

studies to explain political influence in other firm-level decisions, as well as the impact of the political environment on various stakeholders.

Third, this paper joins the ongoing debate about whether political connections and affiliations are important factors in firm operation. We unveil the importance of political connections in firm capital-structure outcomes. The finding that significant changes in firm political positions lead to changes in firm financial flexibility also reinforces the importance of corporate investment in acquiring political connections.

Fourth, by setting our empirical investigation in China, we deliver extra insights into the role of the external political structure in a transitioning economy. Our conclusion, however, may not be limited to the realm of emerging economies. In well-developed countries with fully fledged legal systems, the soft power of political influence plays an equally substantial role in firm operation. A majority of the literature motivating this paper uses data in the United States and developing countries. Thus, the underlying mechanisms, though perhaps amplified in China, are well documented in developing countries.[5] Therefore, it is very likely that political influence has similar effects on SOA in developed countries. This paper may motivate studies in countries with various constitutional structures, legal systems, and fiscal and monetary policies.

The rest of the paper is organized as follows: Section 2 discusses the underlying mechanisms of the link between political influence and financial flexibility and builds testable hypotheses. Section 3 describes the data and the methodology we adopt to measure SOA and key political factors. Section 4 presents the main results and discusses their implications. We employ robustness checks and additional analysis in section 5, and section 6 concludes.

2. Underlying Mechanisms and Hypothesis-Building

As discussed, political factors have a direct and profound influence on economic outcomes, financial markets, and firm-level decision-making. This includes decisions to raise capital,

[5] Though the financial market structure varies across countries, the supply of external capital rather than the forms of capital should affect the impact of political factors on firms' willingness to adjust their target leverage ratios.

when and how to do so, and at what cost. These issues collectively and directly affect firms' capital structures and financial flexibility. In this section, we discuss the underlying mechanisms and build the hypotheses.

At the macro level, it is well documented that political turbulence increases the cost of capital and encourages firms to postpone investment decisions. For example, Cao, Duan, and Uysal (2003) show that firms tend to reduce leverage, remain underleveraged for extended periods, and wait longer to issue debt during periods of high political uncertainty. Waisman, Ye, and Zhu (2015) find that uncertainty associated with the outcome of U.S. presidential elections leads to a 34-basis-point increase in corporate bond spreads, with closer campaign years associated with additional costs. Similarly, Francis, Hasan, and Zhu (2014) show that fluctuations in the political environment impose additional costs on private loan contracts. Gao and Qi (2013) find that in both the primary and secondary markets, municipal bond yields increase sharply by six to eight basis points before gubernatorial elections and then reverse afterward. In a cross-country study, Qi, Roth, and Wald (2010) show that a one-standard-deviation increase in political rights is associated with an 18.6% decline in bond spreads. Furthermore, Julio and Yook (2012, 2016) find that political uncertainty around presidential elections impedes firm-level investment. Also, Cohen, Coval, and Malloy (2011) use changes in congressional committee chairmanships to show that fiscal spending shocks significantly dampen firm-level investment activity.

At the micro level, political connections affect various kinds of capital-related decisions. For instance, Duchin and Sosyura (2012) find that politically connected firms are more likely to be funded, though investments in these firms underperform those of unconnected firms. Goldman, Rocholl, and So (2009) document abnormal stock returns following the announcements of nominations of politically connected individuals to boards. In addition, political connections can expose firms to more favorable policies that shield them from regulatory compliance and legal issues. For example, using government bailouts of 450 politically connected firms from 35 countries during 1997–2002, Faccio, Masulis, and McConnell (2006) show that politically connected firms are significantly more likely to be bailed out than similar, nonconnected firms. Yu and Yu (2011) links firms' lobbying activities with fraud detection and finds that, compared to nonlobbying firms, firms that

lobby have significantly lower chances of being accused of fraud, evade fraud detection 117 days longer, and are 38% less likely to be penalized by regulators.

Despite rich evidence that the macro-level political environment and micro-level political connections affect capital-related decision-making, it is unclear what *collective* effect these mechanisms have on SOA. We argue that political influence may affect SOA in both positive and negative ways.

On one hand, political advantages may raise the speed of adjustment. As mentioned, at the micro level, political connections facilitate access to external financing, lower the cost of capital, infuse firms with more government expenditures and investment, and during extreme financial constraint provide funding and bail-outs (Faccio, Masulis, and McConnell, 2006; Yu and Yu, 2011; Duchin and Sosyura, 2012; Goldman, Rocholl, and So, 2009). At the macro level, certain political environments may nurture firms. For example, when firms are located in areas where top political leaders rank high within the power structure or have stronger ties to top-level political leaders (Qi, Roth, and Wald, 2010; Cohen, Coval, and Malloy, 2011), they have better access financial markets, government expenditures, preferable tax treatments, and other advantages that eventually lead to higher SOA.

On the other hand, the same political advantages may lower the speed of adjustment. First and foremost, a firm with more political advantages enjoys lower legal risk (Agrawal and Knoeber, 2001; Yu and Yu, 2011). It is less likely to be involved in fraud, has more flexibility in accounting transparency (Yu and Yu, 2011; Leuz and Oberholzer-Gee, 2006), has stronger contacts with banks (Chen, Shen and Lin 2014), and receives superior government protections. Thus, the firm does not have to monitor its financial flexibility closely, because it can easily raise additional capital at a desirable cost if its political connections are "in the pocket."

Second, it is not uncommon that executives lack the financial knowledge to make optimal financial decisions. In the United States, for example, many public pension fund managers are more like politicians than financial experts. Their actions may be motivated more by political or social influences than by firm performance, which comes at the

expense of taxpayers and pension beneficiaries (Woidtke, 2002). Politically induced local bias also hampers value maximization (Bradley, Pantzalis, and Yuan, 2016). In developing countries, including China, executives in firms with strong political status may also lack the financial knowledge to optimize firms' capital structures. Some firms, especially those controlled by the state, are run by politicians or managers pursuing political careers. Their goals may deviate from optimizing capital structure in the interest of shareholders.

Third, a capital-structure decision may not be of first-order importance for state-related controlling shareholders with strong political agendas in areas where local political leaders prioritize politics over economic outcomes. The underlying logic is that sacrifices for political consideration are rewarded in other ways or are the result of extracting rent. For example, Hung, Wong & Zhang (2012) point out that political consideration is more important than performance among Chinese state-owned enterprises (SOEs) listed overseas. In the context of capital structure adjustment, for instance, political connections may motivate firms to borrow excessively as a favor to help fulfill local banks' lending targets in order to maintain connections with local politicians.

Of the three mechanisms, micro-level political connections drive the second and third; the first mechanism relates to both the macro- and micro-level factors, as legal protection comes from both local politicians and specific, firm-level political connections.

Based on these two counterarguments, we build competing hypotheses: the aptitude hypothesis and the audacity hypothesis. The aptitude hypothesis theorizes that political advantages make it easier for firms to adjust their financial leverage and result in *higher* speed of adjustment. The audacity hypothesis theorizes that political advantages shelter firms from legal consequences so that deviation from target leverage ratios is not a primary concern, leading to *lower* speed of adjustment. In both cases, the impact may take place at both macro and micro levels. We formulate the two hypotheses as follows:

Aptitude Hypotheses:

H1a: Firms in environments with strong political advantages have <u>high</u> speed of adjustment.

H2a: Firms with strong political connections have high speed of adjustment.

Audacity Hypotheses:

H1b: Firms in environments with strong political advantages have low speed of adjustment.

H2b: Firms with strong political connections have low speed of adjustment.

It is worth noting that the two hypotheses are not mutually exclusive. That is, the underlying mechanisms may influence a firm's ability and willingness to adjust its target leverage ratio. As such, we may not find significant or consistent cross-sectional or time-series results. Also, finding results in favor of one hypothesis does not rule out the possibility that other mechanisms affect SOA in the opposite way. In addition, it is possible that the macro-level political environment and micro-level political connections have opposite impacts on SOA. We test the joint effect in section 4.

3. Data and Key Measurements

This section details the data, measurements of political factors, and measurements of speed of adjustment.

3.1 Data

The primary source of firm-level information is China Stock Market & Accounting Research (CSMAR). CSMAR provides detailed financial statements, stock returns, and corporate governance information about Chinese firms publicly listed on the Shanghai and Shenzhen stock exchanges.

We collect information about firm-level political connections using the CVs of top executives and board members from SinoFIN. Political leaders' profiles and work experience are from ChinaVitae, an online cohort that organizes information regarding Chinese politicians through multiple official sources. State- and provincial-level macro

information is from the National Bureau of Statistics of China. We also utilize the Political Uncertainty Index (China) from Baker, Bloom, and Davis (2012) to build a measure of firm-level political exposure, which we discuss in the following section.

The sample covers 1990 to 2014, and it includes 2,657 unique firms as well as around 24,972 firm-year observations.[6] Summary statistics are in table 1, panel A. Variable construction is detailed in appendix A.

[Insert Table 1 Here]

3.2 Measure of Political Factors

We employ two sets of political factors to capture macro- and micro-level political influence. "Political environment" refers to the business operations setting that is affected by changes in political leaders, major revisions in political policy, global political incidents, etc. "Political connections" are the micro-level ties between political leaders and firms. They are firms' intangible assets. We sort the political factors into macro and micro levels by determining whether certain factors are subject to change by the underlying firm.

As the literature acknowledges, there is no perfect measure of political power among leaders. Hence, we employ multiple proxies for political environment and political connections for more generalizable conclusions; most are adopted from extant literature.

3.2.1 Macro-Level Political Environment

The political environment in the context of this paper refers to political factors that affect how a firm ranks and selects projects, chooses external funding, and achieves targeted outcomes. Political environment incorporates government actions at regional, national, and international levels that affect legal, fiscal, monetary, foreign affairs, and other policies. To

[6] Some of the political factors are missing, including the calculated political exposure (*EXPOSURE*) measure, as some companies have missing stock return information during the sample period. As such, due to missing values for some of the political factor variables, the total number of observations for some subsample analyses is less than 24,972.

quantify the political environment within China, we employ four province-level measurements. These four factors are not subject to change by the underlying firm.[7]

The first proxy is a binary variable that captures whether the incumbent president and/or the premier of China were born or have worked in a certain province. A few studies, including Kriner and Reeves (2015), use a similar measure to examine if a politician's hometown receives preferable treatment. We call this political affiliation (*AFF*) between a specific province and the head of the state. This seemingly coarse measure provides an interesting angle because provinces with direct affiliations with head(s) of state usually enjoy special favorable political treatment and policy flexibility (e.g., Piotroski and Zhang, 2014).

The second proxy stems from incumbent provincial leaders. They are naturally expected to have paramount authority over the operational business environment within the province and are responsible for the province's economic performance (usually quantified as GDP growth). In addition, their political status and rank within the Communist Party of China (CPC) have a direct impact on the political environment in the province.

We focus on the party secretary and governor of each province. They are, respectively, the number one and number two political figures at the provincial level. To scale their political power, we create a discrete variable that captures the locations of the leaders' positions (*ORIGIN*) before they assume their posts as provincial leaders.[8] The variable equals 1 if the politician is from the central government, 2 if from another province, and 3 if from the local province. This categorical approach is based on the assumption and common belief that a politician who assumes a provincial leadership position from a central government post has stronger connections with the core of the CPC (in Beijing) and

[7] One may argue that a firm can relocate and strengthen the impact from some macro-level political factors. However, relocation can be very costly for Chinese public firms, as it is associated with loss of previously accumulated political advantages.

[8] Ansolabehere and Snyder (2006) and Jia, Kudamatsu, and Seim (2015) use a similar proxy for the provincial-level government political measure.

therefore has greater political power compared to those from other provinces or who are promoted locally.

The third proxy captures the political power of provincial leaders. We create a binary variable (*BURO*) that measures whether the province governor or provincial party secretary eventually become a member of the Politburo.[9] The Central Politburo of the Communist Party of China is a group of 25 people who oversee the CPC and, as such, is the top decision-making committee in China. The power of the Politburo resides largely in the fact that its members generally simultaneously hold state-level positions and have control over personnel appointments. Thus, provincial leaders who eventually become Politburo members have top-tier power within the CPC. Note that this measurement biases against recent data points, as we do know which incumbent provincial leaders will eventually become members of the Politburo. However, our results are unaffected if we truncate the sample to the pre-2003 period.

The fourth proxy is a continuous variable that captures political pluralism (*PLU*) at the provincial level; it is a measure from Hasan, Song, and Wachtel (2014). Prior to the 1990s, the People's Congress of China included almost only CPC members.[10] In recent years, approximately one-third of the seats in the national and provincial People's Congresses of China have informally been reserved for members of minority political parties and other independent members, and there is significant variation among provinces. In addition to party differences, differences exist in the composition of interest groups within provincial congresses. We collect data from provincial statistical yearbooks for the distribution of congress members from five "classes": workers, cadres, military officers, intellectuals, and others. Using this information, we create a Herfindahl-Hirschman Index (*HHI*) based on the sum of squares of the proportions of each of the five types of members in the congress. We use 1-*HHI* as a proxy for provincial-level political pluralism (*PLU*). Thus, a higher *PLU* indicates higher political pluralism.

[9] Literature well acknowledges the power of Politburo members in China's decision-making. See, for example, Wang, Zou, and Wang (2014)

[10] The People's Congress of China serves as the legislature. Under China's current constitution, the congress is structured as a unicameral legislature, with the power to legislate, the power to oversee the operations of the government, and the power to elect the major officers.

The summary statistics are in table 1, panel B. Around 16.5% of firms are in provinces affiliated with incumbent state leaders. A majority of provincial governors and provincial party secretaries are from other provinces or promoted locally. The political pluralism measure is well distributed and displays a level of high concentration (we use 1-HHI; thus, the mean of *HHI* is around 0.772).

3.2.2 Micro-Level Political Connections

Political connections are difficult to quantify. We adopt three proxies, including a novel approach to capture a firm's time-variant exposure to political uncertainty. These are the factors that firms are able to change over time.

The first and simplest proxy indicates whether a public firm is under state control (*STATE*). [11] We consider a firm a state-owned enterprise (SOE) if its controlling shareholder (largest shareholder) is either a central or provincial government agency or is a state-owned enterprise. Under this definition, the average state-owned firm has a state ownership between 40% and 42% across the sample period. This is a strong cutoff, as the state could still control many firms in various ways. Thus, this measure should work against us.

The second proxy captures the political status of firms' top executives. Motivated by the leadership literature, if the CPC appoints a firm's top executives, including the CEO, chairman of the board, and/or president, or the executives are members of the CPC, the firm possesses strong political power.[12] Thus, we create a binary variable (*CPC_MEMBER*) that equals 1 if the CPC appoints the top executives or the executives are members of the CPC.[13]

[11] See Szamosszegi and Cole (2011) for a comprehensive discussion of state-owned enterprises and state capitalism in China.

[12] The executive's political status has great implications on how she makes decisions and how political factors influence those decisions (Chen, Ezzamel, and Cai, 2011). In return, the status opens doors and becomes an intangible asset for the firm.

[13] The party status of top executives is from CSMAR and iFind. We cross-check the information with a Baidu search for maximum coverage. A firm is CPC-related when one of its top executives is a CPC member.

The third proxy adopts a novel approach to create a time-variant firm-level exposure to political uncertainty.[14] We call it political exposure (*EXPOSURE*).[15] Instead of quantifying the firm's *ex ante* connections with the political party, we use the *ex post* outcome of firms' political exposure to political uncertainty. Specifically, we assume that the capital market is aware of a firm's political exposure and incorporates it into the stock price. Thus, the sensitivity of a firm's stock returns with regard to changes in political uncertainty should capture its level of political exposure. As such, we regress firms' stock returns on changes in political uncertainty, in addition to the market risk premium, with the following model:

$$R_{it} = \alpha + E_{Pi} \cdot R_{Pt} + \gamma_{Mi} \cdot R_{Mt} + \varepsilon_{it} \qquad (1)$$

in which, R_{it} is a firm's monthly risk premium, and R_{Pt} is the monthly percentage change in China's Political Uncertainty Index from Baker, Bloom, and Davis (2012). R_{Mt} is the monthly value weighted market-risk premium. The coefficient E_{Pi} captures the sensitivity of the firm's stock returns to changes in political uncertainty. We calculate political exposure E_{Pi} over a 36-month window. The results remain robust with a 24-month window. We use the absolute value of E_{Pi} as the proxy for a firm's political exposure. Note that by including R_{Mt}, we eliminate the systematic impact of the political environment on the market level. Thus, E_{Pi} captures the firm-level idiosyncratic political exposure.

The summary statistics for the micro-level proxies are in table 1, panel B. The state controls around 20.5% of the firms. In a subsample consisting of the political status of firms' top executives, 76.5% of firms have CPC member executives. The political exposure measure is well distributed.

To pave the way for multivariate analysis, we look at firm-level capital market activities. Specifically, we look at the frequency and size of capital-market access for net equity, bonds, and loans.[16] We compare frequency and size for groups of firms across the

[14] Francis, Hasan, and Zhu (2014) use a similar measure in a U.S. context to create a firm-level, time-variant, political-exposure measure for U.S. public firms.
[15] We acknowledge that political exposure (*EXPOSURE*) captures the impact of both macro-level and micro-level political factors at the firm level. However, because a firm can change its political exposure by gaining or losing political connections, we thus consider it a micro-level political measure.
[16] The loan information is from CSMAR, the equity and bond information are from iFind.

spectrum of seven political factors. The summary statistics and univariate tests are in table 1, panel C. In almost all the univariate tests, we find that firms in stronger political environments and firms with stronger political connections have more frequent access to the capital markets and larger sizes of adjustment, supporting the aptitude hypothesis.

3.3 Measure of Speed of Adjustment

The key variable of interest is the firms' speed of adjustment of capital structure. We use two approaches to calculate static and time-variant SOAs.

3.3.1 Static Measure of Speed of Adjustment

One empirical challenge for the SOA measure is that it requires multiple years of data to evaluate the optimal capital structure for one firm. Thus, in most studies, SOA is a static value across firms and years.

We follow the methodology detailed in Oztekin and Flannery (2012).

$$LEV_{ij,t} - LEV_{ij,t-1} = \lambda_j (LEV^*_{ij,t} - LEV_{ij,t-1}) + \delta_{ij,t} \quad (2)$$

$$LEV^*_{ij,t} = \beta_j X_{ij,t-1} + F_{ij} \quad (3)$$

Equation (2) explicitly illustrates the definition of speed of adjustment, in which $LEV^*_{ij,t}$ is the optimal leverage ratio of firm *i* in year *t*, and province *j,* determined by a number of macro-level and firm-level factors, as in equation (3); $LEV_{ij,t-1}$ denotes the observed leverage ratio in the previous year, $LEV_{ij,t}$ denotes the observed leverage ratio in the current year, $\delta_{ij,t}$ is the error term, and coefficient λ_j is the SOA of interest. We follow the literature and define *Leverage* as the total book value of debt divided by firm's market value of assets. Market-value of assets is calculated as total assets minus book equity plus market value of equity.

Equation (3) simplifies the way in which the firm's optimal leverage ratio acts as a function of firm and macroeconomic characteristics (Frank and Goyal, 2009). Following Flannery and Rangan (2006), we include a set of firm fixed effects to control for

unobserved firm heterogeneity. The choice of determinants of optimal leverage ratio, $X_{ij,t-1}$, are motivated by Gamba and Triantis (2008). We use firm size, profitability, tangibility, nondebt tax shields, market-to-book ratio, and state ownership as firm-level factors; at the macro level, we include GDP growth, inflation, unemployment, risk-free rate, and CPI.[17]

Substituting equation (3) into (2), we have the following equation for empirical implementations:

$$LEV_{ij,t} = (1-\lambda_j)\, LEV_{ij,t-1} + (\lambda_j \beta_j)\, X_{ij,t-1} + \lambda_j F_{ij} + \delta_{ij,t} \qquad (4)$$

The coefficient of $LEV_{ij,t-1}$ is 1-λ_j, and λ_j is the calculated speed of adjustment for province *j* over the period. A larger value of λ_j suggests faster SOA.

[Insert Table 2 Here]

As show in table 2, the average SOA ($\boldsymbol{\lambda}$) of the entire sample period (1990-2014) is 19.6%, indicating that it takes around 2.55 years for an average firm to halve its optimal leverage.[18] This result is very similar to the one in Qian, Tian, and Wirjanto (2009), who report an average SOA of 18.5% for the 1999-2004 China sample.

When we break the whole sample into pre-2003 (Jiang Zemin) and post-2003 (Hu Jintao) regimes, the SOAs are 28.30% and 18.10%, respectively. The reduction in SOA accompanies the rapid development of the capital markets, product competition, GDP, and almost every aspect of society in China over time. It is pointless to compare the absolute levels of political uncertainty between the two political regimes because the post-2003 regime is labeled the "Harmonious Society," reflecting one of Hu Jintao's top-priority socio-economic visions (Fan, 2006).[19]

[17] It is possible that a firm's political exposure can determine leverage. In empirical tests without the political exposure measurement, we include it as part of the determinant variables in calculating SOA. The results remain robust.
[18] 0.5/19.6%=2.55
[19] China's Party Leadership Declares New Priority: 'Harmonious Society,' by Maureen Fan, *Washington Post Foreign Service*, Thursday, October 12, 2006.

3.3.2 Time-Variant Measure of Speed of Adjustment

The traditional SOA measure is based on the coefficient of a regression. Its static nature poses a challenge to investigate the determinants of SOA. Hence, we adopt the approach in Colak, Flannery, and Oztekin (2015) to address this issue.

We first calculate the predicted firm-year level optimal leverage ratio $\widehat{OLEV_{ij,t}}$ with SOA measured from equation (3):

$$\widehat{OLEV_{ij,t}} = \widehat{\beta_j}\, X_{ij,t-1} \tag{5}$$

Thus, the deviation from the optimal leverage ratio, $\widehat{DLEV_{ij,t}}$, can be expressed as:

$$\widehat{DLEV_{ij,t}} = \widehat{OLEV_{ij,t}} - LEV_{ij,t-1} \tag{6}$$

If we believe that a firm's SOA is affected by political influence, as:

$$\lambda_{ij,t} = \gamma_{i.j.t-1} Politics_{i.j.t-1} \tag{7}$$

we can substitute equations (6) and (7) into equation (2). Thus:

$$LEV_{ij,t} - LEV_{ij,t-1} = \gamma_{i.j.t-1} Politics_{i.j.t-1}\left(\widehat{DLEV_{ij,t}}\right) + \delta_{ij,t} \tag{8}$$

in which the coefficient $\gamma_{i.j.t-1}$ represents the political influence on a firm's SOA.

It is noteworthy that some political factors do not vary greatly over time; thus, we conduct some tests with the static measure of SOA. We use time-variant measures of SOA to test for more time-varying political factors.

3.4 Methodology

To deal with the autocorrelation of leverage and to avoid a biased adjustment-speed estimate, we adopt a two-step generalized method of moments (GMM) (Arellano and Bond 1991; Blundell and Bond, 1998). This approach is widely adopted in SOA studies.

We have a reasonably long panel from 1990 to 2014, although we carry out some tests with shorter panel subsamples. To address the empirical concerns resulting from a short time horizon and a large number of firm observations, we also estimate the regression parameters in first differences to eliminate firm fixed effects. For the lagged instrument variables, we follow the SOA literature and use the second to fourth lagged variables. The results are robust to the change of this setting.

To estimate $\gamma_{i.j.t-1}$, we take a two-step approach. We first estimate equation (4) for λ and $\widehat{\beta_j}$. With the firm-year level optimal leverage ratio $\widehat{OLEV_{ij,t}}$ and distance $\widehat{DLEV_{ij,t}}$ calculated from equations (5) and (6), we further estimate equation (8) with OLS.

The debt structure for publicly listed Chinese firms is slightly different from their U.S. counterparts. Most Chinese companies rely on short-term bank loans, as long-term loan contracts are seldom offered, and the bond market is not a common option for a majority of firms. As Qian, Tian, and Wirjanto (2009) argue, most companies in China maintain their short-term debt for a year or so after the expiration dates, so that short-term debt can easily become long-term debt over time, although it is still recorded as short-term debt on the balance sheet. Thus, we use the market-debt ratio as a leverage measure, defined as a firm's total book value of debt divided by firm's market value of assets. Market-value of assets is calculated as total assets minus book equity plus market value of equity.

4. Main Results and Mechanisms

The nature of static SOA measurements poses an empirical challenge: it is not feasible to test the moderating effect of certain variables on the link between political factors and SOA. As such, to explore the moderating effect, we rely on the calculation of SOA of subsamples and time-variant measurements of SOA.

4.1 Impact of Macro-Level Political Environment on Firms' Speed of Adjustment

The first proxy of macro-level political environment is the affiliations (*AFF*) of the General Secretary of the Central Committee of the CPC (as well as the president of China) and the

Chinese premier. More specifically, we look at the provinces where the state leaders were born and/or worked. The information is from ChinaVitae.[20]

The General Secretary of the Central Committee of the CPC is the number one political figure in China. (Although it is commonly acknowledged that Deng Xiaoping, who never held that office, was paramount leader of China from late 1970s until he passed away on February 19, 1997).

Jiang Zemin was born in Jiangsu province and worked in Shanghai, Jilin, and Beijing throughout his entire political career.[21] He was general secretary of the Central Committee of the CPC from June 24, 1989, to November 15, 2002; president of the People's Republic of China from March 27, 1993, to March 15, 2003; and chairman of the Central Military Commission from March 19, 1990, to March 8, 2005. Jiang remained powerful and influential after Hu Jintao took office. However, to simplify our empirical test, we consider the pre-2003 period to be Jiang's regime. Hu Jintao was also born in Jiangsu and worked in Gansu, Guizhou, Tibet, and Beijing.[22] As the successor of Jiang, Hu took office as general secretary and state president at the end of 2002 and the beginning of 2003, respectively. He became the chairman of the Central Military Commission in March 2005. We consider the post-2003 period to be Hu's regime. Xi Jinping took the state leadership in 2013. However, because our sample period ends in 2014, the time period is too short to include a valid subsample for Xi's regime. Thus, we divide our main sample into Jiang's and Hu's regimes.

The premier of the People's Republic of China is the number two political figure in China. Our sample covers three premiers: Li Peng, from March 25, 1988, to March 17, 1998; Zhu Rongji, from March 17, 1998, to March 16, 2003; and Wen Jiabao from March 16, 2003, to March 15, 2013. Li was born in Shanghai and worked in Heilongjiang, Jilin,

[20] More detailed information is listed in appendix B.
[21] Jiang Zemin Jiang was born on August 17, 1926, in the city of Yangzhou, Jiangsu. His ancestral home was in Anhui. The results are not affected if we include Anhui as his affiliated province.
[22] Hu Jintao was born on December 21, 1942, in Jiangsu province. His branch of the family migrated from Anhui to Jiangsu during his grandfather's generation. The results are not affected if we include Anhui as his affiliated province.

Liaoning, and Beijing; Zhu was born in Hunan and worked in Shanghai and Beijing; Wen was born in Tianjin and worked in Gansu and Beijing.

In the pre-2003 (Jiang) period, we label Jiangsu, Shanghai, Jilin, Beijing, Heilongjiang, Liaoning, and Hunan as affiliated provinces and label the rest unaffiliated; in the post-2003 (Hu) period, we label Jiangsu, Gansu, Guizhou, Tibet, Beijing, and Tianjin as affiliated provinces, and the rest are unaffiliated.

We then look at the SOA for firms headquartered in the affiliated provinces of state leaders during their terms, as well as those headquartered in other provinces, under the assumption that affiliated provinces receive certain privileges in government purchases, policy and regulatory autonomy, fiscal freedoms, etc. The political advantage trickles down to the micro level, so that firms in those provinces may consequently receive preferable political treatment.

[Insert Table 3 Here]

The results are in table 3, panel A. Note that due to the space concerns, we report a condensed summary of calculated SOAs. Consistent with previous measures, SOAs during the pre-2003 period are significantly larger than those in the post-2003 period. For firms in the affiliated provinces, SOAs are also larger than those in unaffiliated provinces. For instance, in the pre-2003 period, firms in the seven provinces affiliated with state leaders have an average SOA of 33.2%, while firms in unaffiliated provinces have an average SOA of 25.5%. The numbers during the post-2003 period are 20.2% and 17.1%, respectively. The results indicate that firms adjust to their optimal capital structures much faster if they are in provinces affiliated with state leaders. This is in line with the aptitude hypothesis, which predicts that a firm in an environment with stronger political advantages has a higher speed of adjustment.

The second proxy goes to the provincial level: *ORIGIN* captures the location of the provincial leaders' previous positions before they assume their current posts. The variable equals 1, 2, or 3 if the politician previously worked in central government, in another province, or was promoted from a local province, respectively. Those from the central

government are commonly believed to have stronger connections to the core of the power structure and therefore have greater political status. The results are in table 3, panel B.

The results show that firms in a given province have a higher SOA (26.5%) when the provincial governor has a central government background. When the governor is from another province or was promoted directly from the current province, the SOAs are 19.0% and 20.1%, respectively). However, when the party secretary has a central government background, firms in that province have an SOA of 19.2%, slightly lower than those where the party secretary is from another province or is promoted directly from the current province (the SOAs are 22.1% and 20.5%, respectively).

In unreported results, we jointly consider the political origin of both leaders. We find that firms have an SOA of 39.5% when both the governor and party secretary are from the central government, but other combinations of the two yield an SOA around 20%. Hence, there is some evidence that provincial leaders' central government background does help raise firms' SOA within an affiliated province. However, the results are more significant for the office of provincial governor or if both provincial leaders are from the central government.

The third proxy (*BURO*) captures whether a provincial governor or a provincial party secretary eventually becomes a member of the Politburo. As in table 3, panel C, firms in provinces where provincial leaders have future Politburo appointments have an SOA of 28.0%, while firms headquartered in other provinces have a significantly lower SOA of 18.9%. [23] This finding is consistent with our prior results that firms in political environments with stronger political advantages are associated with faster SOA.

The fourth proxy, political pluralism (*PLU*), captures the diversification of political representation of the Provincial People's Congresses of China. As shown in table 3, panel D, we find that firms in provinces with higher levels of political pluralism adjust to their optimal capital structures faster than others (SOA 21.4% versus 19.5%), which is consistent

[23] The results are qualitatively unaffected when we restrict the sample to the pre-2003 period to address sample selection issues, because it is unclear whether incumbent provincial leaders during the later sample (post-2003) eventually take positions in the Politburo.

with our conjecture and in line with the common knowledge that diversified political environments benefit firms.

In addition, we conducted Chi-squared test for the statistical significance of calculated static SOAs between sub groups, and in all the scenarios, the difference of SOAs are significant at or above 1% level[24].

In summary, with all four proxies that capture the macro-level political environment, we find that firms headquartered in environments with stronger political advantages have faster SOAs, supporting aptitude hypothesis H1a.

4.2 Impact of Micro-Level Political Connections on Firms' Speed of Adjustment

We now investigate the impact of micro-level political connections on firms' SOA. The first proxy is the level of state control (*STATE*) among public firms. As shown in table 4, panel A, SOEs have an SOA of 21.40%, while the non-SOEs adjust their optimal capital structures at the rate of 19.20%. This finding supports hypothesis H2a (i.e., that political connections are positively related to SOA).

[Insert Table 4 Here]

The second measure, *CPC_MEMBER*, equals 1 if the CPC appoints top executives and/or the executives are members of the CPC. As shown in table 4, panel B, we find that firms with CPC members as top executives show an SOA of 17.90%, but those that do not have a lower SOA of 16.60%. This result is consistent with the previous one, supporting the aptitude hypothesis. Note that half of the observations have missing value on *CPC_MEMBER*, thus the value of SOA is not comparable to other tests.

Last, we conduct a test with the novel measure of time-variant firm-level political exposure (*EXPOSURE*). This variable captures the sensitivity of firms' stock returns to changes in the political environment as a measure of firm-level political risk. We sort the firms into two groups with based on political exposure. Firms with above-median exposure have an SOA of 16.9%, but firms with below-median exposure have an SOA of 21.7%,

[24] We thank two anonymous referees for this suggestion.

indicating that low political exposure (or a high level of political connections) is associated with faster SOA.

To further examine if the effect is linear, we sort firms into tertiles. Firms with high, median, and low levels of political exposure have SOAs of 17.3%, 19.0%, and 25.8%, respectively, suggesting that political exposure has a linear effect on firms' SOA. This result reaffirms the aptitude hypothesis that political connection is positively related to SOA. The Chi-squared tests show that the difference of SOAs are all significant at or above 1% level.

Jointly, we show that all three micro-level political connection measures support aptitude hypothesis H2a, suggesting that firms with stronger micro-level political connections adjust faster to their optimal capital structures.

4.3 Political Impact on Time-Variant Firm-Level Speed of Adjustment

One drawback of the previous results is that we lack the capability to unveil the dynamic and linear impacts of political measures on contemporary SOA when analyzing SOAs among groups subject to various political measures. Thus, we continue the empirical tests with equation (8), which enables investigation of the incremental effect of political influence on normal SOA levels.

As mentioned, in equation (8) the dependent variable is the change in leverage from the previous period: $LEV_{ij,t} - LEV_{ij,t-1}$. We then regress it on the interaction terms of political factors and the deviation from the optimal leverage ratio, $\widehat{DLEV_{ij,t}}$. We standardize all the political factors to have a mean of zero and standard deviation of 1, and then we multiply by $\widehat{DLEV_{ij,t}}$ to ease the interpretation of the results.

The results are presented in table 5, panel A. Columns (1) to (5) examine the effect of each political measure separately; columns (6) to (9) examine the effect by bringing multiple political measures together.

[Insert Table 5 Here]

The results in columns (1) to (4) are consistent with those in previous sections. For example, a higher general (country) level of *Political Uncertainty Index* is related to lower SOA. Economically, a one-standard-deviation increase in the index is associated with a 4.9% reduction in SOA. A one-standard-deviation increase in *PLU* (a higher level means lower concentration, thus lower political pluralism) is associated with a 5.0% reduction in SOA. A local provincial state secretary (higher *ORIGIN*) is also associated with a lower SOA, and a higher level of political exposure (*EXPOSURE*) leads to lower SOA.

Columns (6) to (9) bring multiple measures of macro- and micro-level political influence together. We find consistent results, except that the coefficients of *ORIGIN* change the sign to positive, indicating that a local provincial state secretary (higher *ORIGIN*) is associated with higher SOA. Although this result is not in line with previous ones, its coefficient may simply pick up the time-series effect rather than the cross-sectional effect because the macro-level measures of political environment can be correlated and *ORIGIN* changes infrequently. We further explain this in the following section.

In general, by examining the effect of political factors on dynamic measures of SOA, we strengthen our previous support for hypotheses H1a and H2a. That is, both the macro-level political environment and micro-level political connections are positively related to firms' speed of adjustment.

4.4 Interaction of the Political Environment and Political Connections/Risk

We now combine the macro and micro levels of political measures and investigate their joint effect on SOA. We select political pluralism (*PLU*) and Politburo (*BURO*) as the proxies for the macro level, and we select political exposure (*EXPOSURE*) for the micro level. The results are robust to other combinations of measures. The results are shown in table 6.

[Insert Table 6 Here]

As shown, firms adjust their optimal structures fastest (SOA= 26.9%) when they have lower political exposure and are in provinces with high levels of political pluralism. The lowest SOA (16.8%) comes from firms with higher political exposure and in provinces with high levels of political pluralism, suggesting that micro-level political risk is more influential than macro-level political environment in determining a firm's SOA.

With the Politburo as the macro-level political environment proxy, we find similar results. Firms with lower political exposure in environments with stronger political advantages have the highest SOA (42.6%), and firms with higher political exposure in weaker political environments have the lowest SOA (18.8%). The Chi-squared tests show that the difference of SOAs are all significant at or above 1% level.

In short, the results are consistent with previous findings and further reveal that micro-level political connections may play a more significant role in influencing SOA.

5. Robustness Checks and Discussion

5.1 Endogeneity Control

The main results raise concerns of endogeneity because the link between political influence and SOA may be merely a correlation, or causality may run from the SOA to political measures rather than vice versa. The reverse causality concern is easier to address because, as in many political realms, especially in China, political power trickles down from the central government to every corner of the economy, making it almost impossible for firms to affect the state superstructure with their fiscal policies. Indeed, a large number of studies in political economics (e.g., Julio and Yook, 2016; Colak, Durnev, and Qian, 2016) assume that political influence, such as presidential elections and foreign policy, is independent of daily operational activities regardless of its size.

However, it is still necessary to investigate the causal effect of political factors. To do so, we follow Giannetti, Liao, and Yu (2015), and use the enactment of provincial-level policies that attract highly skilled emigrants as an exogenous shock to political factors.

Since in the 1980s, the number of students from China who study abroad has increased. According to Project Atlas, the total number of Chinese international students reached

459,800 in 2014, of which around 304,040 came to the United States, representing 31.2% of the total U.S. international student body at that time.[25] In the early days, Chinese immigrants would work and stay abroad after finishing their education; however, a sizable number began returning to China from the early 2000s onward. According to the Chinese Statistics Bureau, the number of individuals with foreign academic or training backgrounds returning to China in 2014 reached 370,000, an increase of 3.2% over 2013. The forecast for 2017 is that the inflow of returnees will exceed the outflow of new international students for the first time ever.

The returnees bring back academic and industrial knowledge and experience, as well as an understanding of and a desire for democracy. From the late 1990s, provincial governments started to adopt policies to attract highly skilled emigrants, and they did so at different points in time.[26] Although the main objectives of these policies were to enhance Chinese academic and industrial research, promote entrepreneurial activity, and facilitate the entry of new businesses, the implementation of such policies imposed subtle changes on the local political environment because well-educated returnees demand not only promised packages of subsidized housing, tax benefits, and local grants and awards, but also an improved and more open political and business environment.

We thus use the enactment of provincial policies for attracting expatriates and emigrants as an exogenous shock. We expect it to have a certain impact on political factors, but not (at least not directly) firms' speed of adjustment. Given the nature of the policy enactment as a provincial-level shock, we use it as an instrumental variable for macro-level political pluralism and micro-level political exposure*,* because the country-level measures Political Uncertainty Index and Affiliation to the State Leader *(AFF)* do not capture provincial-level policies. The micro-level state control *(STATE)* and top executive's political status *(CCP_MEMBER)* do not vary greatly over time.[27]

[25] http://www.iie.org/en/Services/Project-Atlas/United-States
[26] A full list of the data can be found in Giannetti, Liao, and Yu (2015)
[27] We follow the suggestion from one anonymous referee and cross-check top executives' political status with the information from Baidu searches to ensure maximum coverage.

Empirically, we use a two-stage least squares (2SLS) approach. In the first stage (unreported), we regress the political variables on emigrant policy, a set of firm-level control variables and firm fixed effects. In the second stage, we adopt equation (8) and use the estimated political variables from the first-stage results as the political variables. The results are in table 7.

[Insert Table 7 Here]

As shown, we find consistent results, both economically and statistically, supporting hypotheses H1a and H2a, reaffirming our main argument. Also, we conduct a number of tests to ensure the appropriateness of the instruments. The Cragg-Donald Wald statistics generate greater value than the Stock-Yogo weak-identification test critical values (Stock and Yogo, 2004), rejecting the null hypothesis that the instruments are weak. The Sargan statistics for the overidentification tests of all instruments yield large *p*-values, which fails to reject the null hypothesis that all instruments are exogenous. The Anderson LM statistics strongly reject the null hypothesis that the instruments are underidentified. These tests, together with the results, provide strong support that political influence has a causal impact on firms' SOA.

5.2 Significant Change in Political Position, Financial Constraint, and Market Financing Conditions[28]

With the time-variant SOA, we further delve into the previously documented positive impact of political factors on firm's SOA.

First, we ask if significant change in political positions lead to changes in firm-level SOA. In another word, if firms with weak political connections or operate in areas with weaker political environment are able to invest or acquire additional political position to improve their speed of adjustment.

[Insert Table 8 Here]

[28] We thank two anonymous referees for the comments that led to this section.

We conduct univariate tests with the dynamic SOA for firms that experience significant improvement in their political positions. The results are in table 8, panel A. We observe strong and significant improvement in SOA for firms that increase their political positions. Similarly, we examine the change in SOA for firms that experience declines in their political positions, and we find the opposite results hold; that is, these firms have slower SOA afterward.

Second, given that political advantage is positively related with financial flexibility, we explore if such positive impact is more pronounced for firms with financial constraints or more pronounced during monetary tightening periods.

We use the *z*-score to sort firms into those with high and low levels of financial constraint, and we use the reserve requirement ratio (*RRR*) set by the People's Bank of China to gauge the ease of monetary policy (Allen, Gu & Qian, 2017). We separate the sample period into monetary tightening and monetary easing periods using the median RRR. The results are in table 8, panel B.

As shown, for firms with high financial constraints during monetary tightening periods, we observe more distinct political impact on SOA, both economically and statistically. In addition, we find that the coefficients for *ORIGIN* and *STATE* change signs between firms with high financial constraints and firms with low financial constraints, as well as between the monetary tightening and monetary easing periods. This provides new insights into the impact of *ORIGIN* and *STATE*, suggesting that when resources are limited or when favorable decisions are made, firms in politically advantageous positions benefit at the expense of the politically disadvantaged.

In columns (3) and (6) of panel B, we use Chi-squared test for the significance of the difference in political influence between high and low financially constraints firms and monetary tightening and easing periods. In most of the cases, the differences are statistically significant[29].

[29] We thank one anonymous referee for the suggestion to include this test.

In aggregate, the new results provide additional support for the aptitude hypothesis that firms change SOA when their political positions change. In addition, the documented positive political influence on SOA is more pronounced for firms with financial constraints during monetary tightening periods.

5.3 Discussion

We show that both macro- and micro-level political factors have a positive and causal effect on firms' speed of adjustment. The link and the findings have several implications.

First, we argue in section 2 that political factors may affect a firm's capital structure in both directions. Political connections grant firms to have short-cut access to capital markets and protect firms from legal complications when they face financial distress. Our results consistently support the conjecture that firms adjust to their optimal capital structures and reap the benefits associated with target debt ratios. We do not, however, completely rule out the possibility that some firms, though they may have opportunities for external financing, still choose to deviate from their optimal leverage ratios. Thus, our results should be interpreted as quantitatively conservative. In other words, firms with stronger political connections or those operating in political environments with stronger political advantages should be able to adjust to their optimal leverage faster than we have documented if they choose to do so.

Second, we hypothesize that politically connected firms may not always adjust to their optimal leverage, because executives lack strong financial knowledge and/or because of other political priorities. However, we do not find that such channels dominate the way firms project their capital-structure decisions. On the contrary, firms that are in better political positions act to their own advantage. It is possible that the executives of state-owned firms may be less financially knowledgeable or act on other agendas under the influence of the government, but the stronger political advantages they possess overcome such weaknesses.

Third, the literature provides abundant evidence that politician/firm or politician/manager connections are important for external financing and cost of capital. For

further study, it would be interesting to examine the effects of these specific personnel-level links and look into their overall impact on firms' speed of adjustment to their optimal capital structure.

6. Conclusion

This paper examines how political factors, including both macro-level political environment and micro-level political connections, affect the speed at which firms adjust their capital structures. We conduct an empirical investigation within the political realm of China, where the single-party political system provides an ideal setting to quantify political factors, in contrast to Western countries where politically induced business cycles create bipartisan policy changes and confound micro-level political connections.

We find that at the macro level, firms operating in environments with higher political advantages (proxied by a province's affiliation to the head of state as well as provincial leaders' political status and rank in the party) enjoy higher speed of adjustment; at the micro level, firms owned by the state, firms with CPC members as executives, and firms bearing lower exposure to changes in political uncertainty also have higher speed of adjustment. The effect is economically significant. For example, in provinces where political leaders possess higher political status and rank, firms adjust to their SOA 48% faster than those in other provinces. State-owned firms and firms with CPC members as executives also enjoy around 8% faster SOA than their counterparts.

Our findings enhance the understanding of how political influence affects firms' capital structures in general, as a collective effect of its impact on financing, cost of capital, and other firm-level decision-making. These findings in turn shed light on how politically induced capital-structure changes affect other decision-making at the firm level.

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Appendix A: Variable Definitions

Variable Name	Description
Firm Size	Log of total assets
Leverage	Total book value of debt divided by firm's market value of assets. Market-value of assets is calculated as total assets minus book equity plus market value of equity.
Tangibility	Net property, plant, and equipment divided by total assets
NDTS	Nondebt tax shields, depreciation divided by total assets
Profitability	Earnings before interest and tax divided by total assets
Market-to-Book Ratio	Market-to-book ratio of a firm
Tobin's Q	Ratio of the market value of a firm's assets to the replacement cost of the firm's assets.
Affiliation of the State Leader (*AFF*)	Binary variable that equals 1 if the state leader was born or has worked in the province, zero otherwise.
Origination of the Leader (*ORIGIN*)	The variable takes equals 1 if the politician's previous post was from central governance, 2 if from another province, and 3 if from the local province.
Political Pluralism (*PLU*)	Herfindahl-Hirschman Index (*HHI*) based on the sum of squares of the proportions of each of these five types of congress members: farmers and workers, military officers, cadres, intellectuals, and others.
Politburo (*BURO*)	Binary variable that equals 1 if the province leader eventually becomes a member of the Politburo, and zero otherwise.
State Ownership (*STATE*)	Binary variable that equals 1 if a firm's controlling shareholder (largest shareholder) is either a central or provincial government agency or state-owned enterprise, and zero otherwise
CPC Member/Appointment (*CPC_MEMBER*)	Binary variable that equals 1 if firm's top executive(s) is a CPC member, and zero otherwise.
Political Exposure (*EXPOSURE*)	See main text.

Appendix B: Political Leaders of P.R. China

This table shows the tenure and affiliated provinces of the presidents and premiers or China from 1993 to 2013. The affiliated provinces are those in which the politician was born and/or has worked.

Name	Title	Tenure	Affiliated Provinces
Jiang Zemin	General Secretary of the Central Committee of the Communist Party of China	June 24, 1989 - Nov. 15, 2002	Jiangsu, Shanghai, Jilin, Beijing
	President of the People's Republic of China	Mar. 27, 1993 - Mar. 15, 2003	
	Chairman of the Central Military Commission	Mar. 19, 1990 - Mar. 8, 2005	
Hu Jintao	General Secretary of the Central Committee of the Communist Party of China	Nov. 15, 2002 – Nov. 15, 2012	Jiangsu, Gansu, Guizhou, Tibet, Beijing
	President of the People's Republic of China	Mar. 15, 2003 – Mar. 14, 2013	
	Chairman of the Central Military Commission	Mar. 13, 2005 – Mar. 14, 2013	
Li Peng	Premier of the People's Republic of China	Mar. 25, 1988 – Mar. 17, 1998	Heilongjiang, Jilin, Liaoning, Beijing
Zhu Rongji	Premier of the People's Republic of China	Mar. 17, 1998 – Mar. 16, 2003	Hunan, Beijing, Shanghai
Wen Jiabao	Premier of the People's Republic of China	Mar. 16, 2003 – Mar. 15, 2013	Tianjin, Gansu, Beijing

Table 1: Summary Statistics
Panel A shows firm characteristics and macroeconomic factors. Panel B shows the main measurements for political environment and political connection/risk. Panel C reports the frequency and size of capital-market access across seven political factors. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. Variables construction is detailed in appendix A.

Panel A: Firm Characteristics and Macroeconomic Factors

Variable	N	Mean	S.D.	P5	P25	P50	P75	P95
Firm Characteristics								
Firm Size	24,972	21.37	1.27	19.59	20.53	21.2	22.03	23.75
Leverage	24,972	0.202	0.161	0	0.0654	0.185	0.305	0.488
Tangibility	24,972	0.262	0.179	0.0164	0.123	0.23	0.375	0.608
NDTS	24,972	0.0207	0.0167	0	0.00839	0.0174	0.0294	0.0531
Profitability	24,972	0.0262	0.0775	-0.104	0.0027	0.0307	0.0645	0.133
Market-to-Book Ratio	24,972	3.392	3.139	0.173	1.586	2.603	4.276	9.006
Tobin's Q	24,972	2.337	1.606	0.797	1.304	1.865	2.832	5.427
Macroeconomic Factors								
GDP	24,972	35695	25177	5425	13539	30730	52840	85373
Unemployment	24,972	0.256	0.15	0	0.1	0.3	0.4	0.4
CPI	24,972	102.7	3.284	98.5	101.1	102.4	103.8	106.3
Risk-Free Rate	24,972	4.228	1.664	3.2	3.8	3.9	3.9	9.4

Panel B: Political Environment and Political Connection/Risk

Variable	N	Mean	S.D.	P5	P25	P50	P75	P95
Affiliation of the State Leader (*AFF*)	24,972	0.165	0.372	0	0	0	0	1
Origination of the Leader (*ORIGIN*) Governor	24,470	2.362	0.760	1	2	3	3	3
Origination of the Leader (*ORIGIN*) State Secretary	24,470	1.881	0.656	1	1	2	2	3
Political Pluralism (*PLU*)	24,951	0.228	0.430	0	0	0	0	1
Politburo (*BURO*)	24,470	1.041	0.0587	0.927	1.007	1.045	1.079	1.171
State Ownership (*STATE*)	24,951	0.205	0.253	0	0	0.0201	0.425	0.675
CCP Member/Appointment (*CCP_MEMBER*)	11,142	0.765	0.424	0	1	1	1	1
Political Exposure (*EXPOSURE*)	23,879	0.0225	0.0244	0.001	0.007	0.0149	0.0283	0.0726

Panel C: Frequency and Size of Capital Market Access across Seven Political Factors

	Frequency of Adjustment (Percent)				Size of Adjustments (Percent)		
	Access	Net Equity	Net Bond	Net Loan	Net Equity	Net Bond	Net Loan
Affiliation of the State Leader (*AFF*)							
Yes	0.912	0.704	0.441	0.895	0.068	0.003	0.209
No	0.791	0.531	0.230	0.761	0.064	0.002	0.179
Difference	0.121***	0.173***	0.211***	0.135***	0.003	0.001**	0.030***
Origination of the Leader (*ORIGIN*)							
Central Government	0.949	0.756	0.505	0.929	0.071	0.004	0.206
Others	0.915	0.665	0.391	0.901	0.057	0.003	0.227
Difference	0.034***	0.092***	0.114***	0.028***	0.014***	0.000	-0.021***
Political Pluralism (*PLU*)							
High	0.827	0.645	0.427	0.814	0.067	0.003	0.205
Low	0.815	0.633	0.393	0.793	0.057	0.003	0.195
Difference	0.012**	0.013*	0.034***	0.021***	0.010***	0.000	0.010***
Politburo (*BURO*)							
Yes	0.945	0.768	0.533	0.928	0.068	0.004	0.220
No	0.923	0.607	0.271	0.898	0.064	0.002	0.209
Difference	0.022***	0.161***	0.263***	0.031***	0.004	0.002***	0.011**
State Ownership (*STATE*)							
Yes	0.857	0.670	0.381	0.832	0.055	0.003	0.244
No	0.865	0.613	0.337	0.847	0.046	0.002	0.212
Difference	-0.008	0.056**	0.044*	-0.015	0.010**	0.001*	0.033**
CCP Member/Appointment (*CCP_MEMBER*)							
Yes	0.898	0.684	0.387	0.871	0.064	0.003	0.215
No	0.853	0.601	0.328	0.837	0.042	0.003	0.216
Difference	0.045***	0.083***	0.059***	0.033***	0.022***	0.000	-0.001
Political Exposure (*EXPOSURE*)							
Low	0.899	0.684	0.453	0.885	0.044	0.004	0.225
High	0.86	0.658	0.434	0.844	0.035	0.003	0.219
Difference	0.038***	0.026***	0.019*	0.040***	0.008***	0.001***	0.005*

Table 2: Measurement of Speed of Adjustment

This table shows the calculated SOA(**λ**). Column (1) is the entire sample. Columns (2) and (3) are for pre-2003 and post-2003 subsamples, respectively. Columns (4) and (5) are for periods with high and low political uncertainty, respectively. Chi-squared test is conducted for the statistical inference of the **λ** between high and low political uncertainty periods. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. The way we construct the variables is detailed in appendix A.

		Pre-2003	Post-2003	High PU	Low PU
	(1)	(2)	(3)	(4)	(5)
Variable	Leverage	Leverage	Leverage	Leverage	Leverage
Leverage(*t*-1)	0.804***	0.717***	0.819***	0.817***	0.785***
	(0.014)	(0.055)	(0.020)	(0.028)	(0.029)
Firm Size	0.007***	0.009***	0.007***	0.006***	0.007***
	(0.001)	(0.002)	(0.001)	(0.001)	(0.001)
Tangibility	0.057***	0.016	0.064***	0.044***	0.083***
	(0.008)	(0.013)	(0.010)	(0.010)	(0.011)
NDTS	-0.072***	-0.470***	-0.478***	-0.454***	-0.703***
	(0.008)	(0.136)	(0.087)	(0.092)	(0.108)
Profitability	-0.651***	-0.437***	-0.255***	-0.284***	-0.313***
	(0.081)	(0.044)	(0.019)	(0.024)	(0.025)
Market-to-Book Ratio	-0.004**	0.002	0.000	0.002**	-0.000
	(0.002)	(0.001)	(0.001)	(0.001)	(0.001)
State Ownership	0.014***	-0.011*	0.006	0.010**	0.010*
	(0.003)	(0.005)	(0.003)	(0.003)	(0.004)
Constant	-0.121***	-0.097*	-0.107***	-0.073***	-0.093***
	(0.016)	(0.042)	(0.016)	(0.019)	(0.020)
Observations	24972	6,072	18,900	13,880	11,092
No. Firms	2,658	1,225	2,635	2,636	2,527
Speed of Adjustment (**λ**)	19.6%	28.30%	18.10%	18.3%	21.5%***

Table 3: Political Environment and Speed of Adjustment

This table shows the calculated SOA(**λ**) under various factors of political environment. The table is presented in a condensed pattern. Panel A uses affiliation of the state leader (*AFF*) as the proxy for political environment. Panel B uses origination of the province leader (*ORIGIN*) as the proxy for political environment. Panel C captures whether the provincial party secretary and/or governor eventually became a Politburo (*BURO*) member. Panel D uses political pluralism (*PLU*) as the proxy for political environment. Chi-squared test is conducted for the statistical inference of the **λ** across subsamples. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. The way we construct the variables is detailed in appendix A.

Panel A: Affiliation of the State Leader (*AFF*)

	Related Provinces	Unrelated Provinces
Jiang Zemin (1993-2003)	33.2%	25.5%***
Hu Jintao (2003-2013)	20.2%	17.1%***

Panel B: Origination of the Province Leader (*ORIGIN*)

	Central Government	Other Provinces	Local Province
Governor	26.5%	19.0%***	20.1%***
Party Secretary	19.2%	22.1%**	20.5%**

Panel C: Politburo (*BURO*)

	Yes	No
If provincial party secretary and/or governor became politburo member	28.0%	18.9%***

Panel D: Political Pluralism (*PLU*)

	Low	High
Provincial Political Pluralism	19.5%	21.4%***

Table 4: Political Connection and Speed of Adjustment

This table shows calculated SOA(**λ**) under various factors of political connections/risk. Panel A uses state ownership (*STATE*) as the proxy for political connection. Panel B uses CPC member/appointment (*CPC_MEMBER*) as the proxy for political connection. Panel C uses *political exposure* (*EXPOSURE*) as the proxy for political risk. Chi-squared test is conducted for the statistical inference of the **λ** across subsamples. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. Variables construction is detailed in appendix A.

Panel A: State Ownership (*STATE*)

	Low	High
State Ownership	19.20%	21.40%***

Panel B: CPC Member/Appointment (*CPC_MEMBER*)

	Low	High
CPC Member/Appointment	16.60%	17.90%***

Panel C: Political Exposure (*EXPOSURE*)

	High	Median	Low
Political Exposure (Two Groups)	16.9%		21.7%***
Political Exposure (Three Groups)	17.3%	19.0%***	25.8%***

Table 5: Time-Variant Speed of Adjustment

This table shows the results of equation (8), which investigates the impact of time-variant political factors on the time-variant SOA(**λ**) measures. The dependent variable is the change in leverage from the previous period. The independent variables are the interaction terms between the political factors and the deviation from the optimal leverage ratio, $\widehat{DLEV}$. All the political factors are standardized first and multiplied by $\widehat{DLEV}_{ij,t}$, to ease interpretation of the results. The firm fixed effect is control. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. Variables construction is detailed in appendix A.

Variable	(1) DLEV	(2) DLEV	(3) DLEV	(4) DLEV	(5) DLEV	(6) DLEV	(7) DLEV	(8) DLEV	(9) DLEV
Political Uncertainty Index × $\widehat{DLEV}$	-0.049***					-0.028***	-0.050***	-0.032***	-0.027***
	(0.001)					(0.004)	(0.001)	(0.004)	(0.004)
Political Pluralism (*PLU*) × $\widehat{DLEV}$		-0.050***				-0.023***		-0.025***	-0.032***
		(0.001)				(0.004)		(0.004)	(0.005)
Origination of the Leader (*ORIGIN*) × $\widehat{DLEV}$			-0.034***					0.006***	0.005***
			(0.001)					(0.002)	(0.002)
Political Exposure (*EXPOSURE*) × $\widehat{DLEV}$				-0.014***			-0.002**	-0.002*	-0.002*
				(0.001)			(0.001)	(0.001)	(0.001)
State Ownership (*STATE*) × $\widehat{DLEV}$					-0.010***				0.006***
					(0.001)				(0.001)
Constant	0.004***	0.004***	0.004***	0.004***	0.004***	0.004***	0.004***	0.004***	0.004***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Observations	24,708	24,708	24,304	23,731	24,708	24,708	23,731	23,731	23,731
R-squared	0.181	0.180	0.115	0.066	0.049	0.184	0.191	0.194	0.196
Adj. R-squared	0.083	0.081	0.006	-0.051	-0.065	0.086	0.089	0.092	0.094

Table 6: Interaction of Political Environment and Political Connection/Risk

This table shows SOA(**λ**) under the interaction of political environment and political connection. The first half of the table shows SOA under the interaction of *PLU* and *EXPOSURE*. The second half of the table shows SOA under the interaction of *BURO* and *EXPOSURE*. Chi-squared test is conducted for the statistical inference of the **λ** across subsamples. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. Variables construction is detailed in appendix A.

		Overall	Exposure (H)	Exposure (L)
Political Pluralism (*PLU*)	Low	19.5%	20.0%	22.2%**
	High	21.4%***	16.8%***	26.9%***

		Overall	Exposure (H)	Exposure (L)
Politburo (*BURO*)	No	18.9%	18.8%	21.9%**
	Yes	28.0%***	20.1%***	42.6%***

Table 7: Exogenous Shock with Emigrant Policy

This table shows the two-stage least squares (2SLS) results using provincial-level emigrant policy change as an exogenous shock. The instrumental variable is the status of emigrant policy. We omit the first-stage results to conserve space. The second-stage model follows equation (8), which investigates the impact of time-variant political factors on time-variant SOA(**λ**) measures. The dependent variable is the change in leverage from the previous period. The independent variables are the interaction terms between the political factors and the deviation from the optimal leverage ratio, $\widehat{DLEV}$. All the political factors are standardized first and multiplied by $\widehat{DLEV}_{ij,t}$, to ease interpretation of the results. The firm fixed effect is controlled.

The table also contains statistical tests of weak identification, overidentification, and underidentification for the use of instrument variables. The values in parentheses are the standard errors. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. The way we construct the variables is detailed in appendix A.

		(1)	(2)
Variable		DLEV	DLEV
Political Pluralism (*PLU*) × $\widehat{DLEV}$		-0.020***	
		(0.001)	
Political Exposure (*EXPOSURE*) × $\widehat{DLEV}$			-0.046***
			(0.002)
Constant		0.004***	0.004***
		(0.001)	(0.001)
Observations		24,708	23,731
Adj. R-squared		0.051	-0.145
Underidentification Test (Anderson LM statistic)		8841	1984
	P-value	(0.000)	(0.000)
Weak-Identification Test (Cragg-Donald Wald F statistic)		543,382	1,369
Stock-Yogo Weak ID Test Critical Values		19.93	19.93
Sargan Statistic (Overidentification Test)		180.0	27.26
	P-value	(0.000)	(0.000)

Table 8: Significant Change in Political Position, Financial Constraint, and Market Financing Condition
Panel A reports the univariate tests using time-variant SOA for firms that experience significant changes in their political positions. Panel B reports the political impact on the speed of adjustment with the time-variant measurements for firms with high and low levels of financial constraint and for a subsample period with monetary tightening and monetary easing policy. We use *z*-score as a measure of financial constraint and use the reserve requirement ratio (*RRR*) set by the People's Bank of China for the easiness of monetary policy. The dependent variable is the change in leverage from the previous period. The independent variables are the interaction terms between the political factors and the deviation from the optimal leverage ratio, $\widehat{DLEV}$. All the political factors are standardized first and multiplied by $\widehat{DLEV}_{IJ,t}$, to ease interpretation of the results. The firm fixed effect is controlled. Columns (3) presents the Chi-squared test for the comparison of the coefficients between high and low financially constraint firms, and column (6) presents the Chi-squared test for the comparison of the coefficients between monetary tightening and easing periods. *, **, and *** denote significance at 5%, 1%, and 0.1% level, respectively. Variables constructions is detailed in appendix A.

Panel A: Significant Change in Political Position and Speed of Adjustment

	(1) SOA(*t*-1)	(2) SOA(t)	(3) Diff (2)-(1)
State Ownership (*STATE*)			
Increase from below 50% to over 50%	16.71%	20.47%	3.75%*
Decrease from above 50% to below 50%	19.41%	13.59%	-5.82%**
CCP Member/Appointment (*CCP_MEMBER*)			
Gained Top Executives with CCP Member	17.93%	19.37%	1.44%*
Lost Top Executives with CCP Member	18.09%	16.92%	-1.17%*
Political Exposure (*EXPOSURE*)			
50% Decrease in Political Exposure	16.07%	18.95%	2.88%***
50% Increase in Political Exposure	20.10%	17.41%	-2.69%***

Panel B: Financial Constraint and Market Financing Condition

VARIABLES	(1) High Financial Constraint	(2) Low Financial Constraint	(3) Chi-squared test (2)-(1)	(4) Monetary Tightening	(5) Monetary Easing	(6) Chi-squared test (5)-(4)
Political Uncertainty Index × $\widehat{DLEV}$	-0.059***	-0.018***	14.93***	-0.081***	-0.011	11.23***
	(0.010)	(0.007)	(0.000)	(0.015)	(0.013)	(0.000)
Political Pluralism (*PLU*) × $\widehat{DLEV}$	-0.044***	-0.015***	6.82**	-0.109***	-0.008	9.63**
	(0.014)	(0.002)	(0.009)	(0.016)	(0.016)	(0.002)
Origination of the Leader (*ORIGIN*) × $\widehat{DLEV}$	-0.003***	0.009***	9.34**	-0.007***	0.008***	7.42**
	(0.000)	(0.001)	(0.002)	(0.001)	(0.002)	(0.006)
Political Exposure (*EXPOSURE*) × $\widehat{DLEV}$	-0.003**	-0.001***	1.93	-0.005***	0.001	6.48*
	(0.001)	(0.000)	(0.165)	(0.001)	(0.006)	(0.011)
State Ownership (*STATE*) × $\widehat{DLEV}$	0.006**	-0.004**	8.12**	0.008**	-0.003***	4.72*
	(0.003)	(0.001)	(0.004)	(0.003)	(0.000)	(0.030)
Constant	-0.030***	0.028***		-0.004***	0.012***	
	(0.001)	(0.001)		(0.000)	(0.001)	
Observations	10,263	11,521		10,660	11,124	
Adj. R-squared	0.235	0.147		0.156	0.222	